

Department of Water Resources Electric Power Fund Financial Statements

September 30, 2005



Department of Water Resources Electric Power Fund

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Department of Water Resources Electric Power Fund Management's Discussion and Analysis

USING THIS REPORT

This discussion and analysis is designed to assist the reader in focusing on significant financial issues and activities and to identify any significant changes in financial position of the Department of Water Resources Electric Power Fund (the Fund), which is administered by the California Department of Water Resources (DWR). Readers are encouraged to consider the information presented in conjunction with the financial statements as a whole, which follows *Management's Discussion and Analysis*. This discussion and analysis and the financial statements do not relate to DWR's other governmental and proprietary funds.

The basic financial statements include three required statements, which provide different views of the Fund. They are: the statement of net assets, the statement of revenues, expenses and changes in net assets, and the statement of cash flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statement of net assets includes all assets and liabilities as of a specified date. The statement of revenues, expenses and changes in net assets presents all revenues, expenses, and changes in net assets for a specific period. The statement of cash flows reports cash receipts, disbursements and the net change in cash resulting from three principal types of activities: operating, financing and investing. In order for the basic financial statements to be complete, they must be accompanied by a complete set of footnotes. The notes to the financial statements provide disclosures which are required to conform with generally accepted accounting principles. The Fund is required to follow accounting standards promulgated by the Governmental Accounting Standards Board.

This report should be read in conjunction with the Fund's June 30, 2005 audited financial statements.

BACKGROUND

The Fund was established in January 2001 through legislation to assist mitigation of the effects of a statewide energy supply emergency. DWR has the authority to secure and retain title to power for resale to end use customers of the State's investor owned utilities (IOUs) under power supply contracts entered into prior to January 1, 2003. The scheduling, dispatch, and certain other administrative functions for the long-term contracts are performed by the IOUs. However, DWR retains the legal and financial responsibility for the contracts until such time as there is complete assignment of the contracts to the IOUs and release of DWR. DWR is entitled to recover revenue requirements for authorized activities, including but not limited to debt service, the costs of power purchases, administrative expenses and reserves.

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Management's Discussion and Analysis

STATEMENTS OF NET ASSETS

The Fund's assets, liabilities and net assets as of September 30, 2005 and June 30, 2005 are summarized as follows (in millions):

	September	June
Long-term restricted cash and investments	\$ 1,482	\$ 1,482
Recoverable costs, net of current portion	7,358	7,356
Restricted cash and investments:		
Operating and priority contract accounts	1,060	1,387
Bond charge collection and bond charge payment accounts	773	570
Other investments	325	80
Recoverable costs, current portion	580	573
Interest receivable	35	26
Total assets	<u>\$ 11,613</u>	<u>\$ 11,474</u>
Net assets	\$ -	\$ -
Long-term debt, including current portion	10,971	10,982
Accounts payable	479	424
Accrued interest payable	163	68
Total capital and liabilities	<u>\$ 11,613</u>	<u>\$ 11,474</u>

Long-Term Restricted Cash and Investments

As anticipated, there is no change in the \$555 million balance in the Operating Reserve Account at September 30, 2005 from June 30, 2005. The amount is determined in accordance with the bond indenture and is equal to twelve percent of projected annual operating expenses of the Fund for calendar year 2005 as forecast in the DWR 2005 Revenue Requirement determination. Also, the balance of the Debt Service Reserve Account remains at \$927 million.

Recoverable Costs, Net of Current Portion

Long-term recoverable costs consist of costs that are recoverable through future billings. The \$2 million net increase in long-term recoverable costs during the three month period ended September 30, 2005 is net of 1) operating expenses which exceed operating revenues by \$142 million, and 2) Bond charge revenue exceeding interest expense by \$140 million.

Restricted Cash and Investments

The \$1.060 billion balance in the Operating and Priority Contract Accounts at September 30, 2005 is \$149 million higher than forecast in DWR's 2005 Revenue Requirement determination, principally due to the receipt of non-forecasted energy settlements earlier in the calendar year. The Operating and Priority Contract Accounts were forecast in the 2005 Revenue Requirement to decrease by \$253 million during the three month period ending September 30, 2005 due to the ability to decrease cash balances and still remain in compliance with bond indenture requirements as outlined in the 2005 Revenue Requirement.

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The actual decrease of \$327 million during the three month period ended September 30, 2005 is \$74 million greater than forecast and is primarily due to higher fuel costs.

The Bond Charge Collection and Bond Charge Payment Accounts increased by \$203 million in this period in anticipation of the interest payment due in November 1, 2005, and the next principal payment due May 1, 2006. The balance in the account at September 30, 2005 is \$39 million higher than forecast in the 2005 Revenue Requirement.

From the dates of issuance of the revenue bonds through September 30, 2005, the balances in each of the restricted cash and investments accounts met or exceeded balances required by the Bond Indenture.

Other Investments

Other investments consists of a brokerage account with a national brokerage firm in order to hedge natural gas costs for fuel used in the production of power under the terms of certain power purchase contracts.

Other investments increased by \$245 million in the three months ended September 30, 2005 due to the increase in number and value of the open positions as a result of the overall increase in natural gas prices. At September 30, 2005, the account consists of money market obligations, US Treasury bills, and government bonds valued at \$46 million and financial futures and options valued at \$279 million.

Recoverable Costs, Current Portion

The current portion of recoverable costs reflects billings to IOU customers that have not yet been collected and amounts due for surplus sales of energy and gas. The current portion of recoverable costs increased by \$7 million in the three months ended September 30, 2005. The increased sale of power in the summer months was offset by lower remittance rates, resulting in a balance at September 30, 2005 that is comparable to that at June 30, 2005.

Long-Term Debt

The \$11 million decrease in long-term debt for the three month period ended September 30, 2005 is solely attributable to the amortization of premium.

Accounts Payable

Accounts payable at each quarter's end are comparable and reflect one month's accrual for power and fuel purchases, as payments are normally made on the 20th of the month following purchase.

Accrued Interest Payable

The increase in accrued interest payable is anticipated as the fixed rate bonds provide for semi-annual payments on May 1st and November 1st, while the variable rate bonds provide for more frequent payments.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

The Fund's activities for the three months ended September 30, 2005 and 2004 are summarized as follows (in millions):

	2005	2004
Revenues:		
Power charges	\$ 870	\$ 1,265
Surplus sales	139	65
Bond charges	216	243
Interest income	38	25
Total revenues	<u>1,263</u>	<u>1,598</u>
Expenses:		
Power purchases	1,140	1,426
Interest expense	114	110
Other expenses	11	17
Recovery of recoverable costs	(2)	45
Total expenses	<u>1,263</u>	<u>1,598</u>
Net income	-	-
Net assets, beginning of period	-	-
Net assets, end of period	<u>\$ -</u>	<u>\$ -</u>

Power Charges

Power charges decreased by \$395 million in the three months ended September 30, 2005 compared to the same three month period in 2004. The volume of power sold in the three month period ended September 30, 2005 was 7.5 percent less than the same period in 2004 because of the expiration of a major contract at December 31, 2004. Additionally, 2005 remittance rates, which are based on DWR's 2005 Revenue Requirement, are lower than the 2004 remittance rates. DWR is able to reduce remittance rates in calendar year 2005 to purposefully reduce the cash balance in the Operating Account and yet maintain balances in the Operating Account, Priority Contract, and Operating Reserve Account in excess of bond indenture requirements.

Surplus Sales

Surplus sales in the quarter ended September 30, 2005 are \$74 million greater than in the same period in 2004. Although the quantities of surplus energy sold are comparable during the two periods, the dollar value of sales of excess natural gas in 2005 rose reflecting overall rising natural gas prices.

Bond Charges

Bond charges for the three months ended September 30, 2005 are \$27 million lower than the same period in 2004; however, they are adequate to meet all debt service requirements and maintain bond indenture

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

required account balances in the Bond Charge Collection, Bond Charge Payment, and Debt Service Reserve Accounts.

Interest Income

Interest income for the three months ended September 30, 2005 is \$13 million higher than in the same period in 2004 and is attributable to increased rates received on investments in the State of California Investment Pooled Money Investment Account-Surplus Investment Fund.

Power Purchases

DWR power costs are \$286 million lower in the three months ended September 30, 2005 than in the same period in 2004. This reduction includes the impact of a \$245 million unrealized marked-to-market value increase in the other investment account used for natural gas hedging. Also, there is an approximate 10 percent decrease in the amount of power purchased due the expiration of a contract at December 31, 2004. After considering the increased gas prices and reduced consumption of gas associated with the expired power purchase contract, the net cost of gas decreased by \$5 million between the two quarters.

Interest Expense

Interest expense in the three months ended September 30, 2005 is \$4 million higher than in 2004 as the result of increased interest rates on variable rate debt.

Other Expenses

Administrative expenses decreased \$6 million in the three months ended September 30, 2005 compared to the same period in 2004 due to a reduction in statewide pro-rata cost allocation to the Fund and decreased costs incurred for contract renegotiation and litigation activities.

Recovery (Deferral) of Recoverable Costs

The individual components of the recovery (deferral) of recoverable costs are as follows (in millions):

	2005	2004
Operations	\$ (142)	\$ (113)
Debt service and related costs	<u>140</u>	<u>158</u>
	<u>\$ (2)</u>	<u>\$ 45</u>

Operations

The deferral of recoverable costs in the three months ended September 30, 2005 and the same period in 2004 are comparable. DWR was able to decrease power charges and still maintain operating funds that are in excess of the amount required by the bond indentures because cash balances are in excess of indenture requirements.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Debt Service and Related Costs

The recovery of debt service and related costs are comparable between the three month periods ended September 30, 2005 and 2004, and are comprised solely of the difference between bond charges and interest income less interest expense.

FUTURE OPERATIONS

In August 2005 the Governor introduced legislation that would establish a Department of Energy through the consolidation of the functions of several departments, commissions and offices that currently implement state energy programs. If the legislation were to be enacted, all of the powers, duties, responsibilities, rights, obligations, liabilities and jurisdiction of DWR under Division 27 of the California Water Code would be assumed by the Department of Energy.

DWR or its successor will administer the Fund until such time as the revenue bonds are completely retired. Revenue requirements for the repayment of the bonds will be determined at least annually and submitted to the CPUC for implementation. Under the terms of the rate agreement between the CPUC and DWR, the CPUC is required to set rates for the customers of the IOUs and ESPs such that the Fund will always have monies to pay the principal of and interest on the bonds and all other bond related costs when due.

DWR has the authority to administer all power supply contracts for the life of the contracts. Over 95% of the volume of power under contract expires by December 31, 2011 and the last of the contracts expires in 2017. Revenue requirements for the payment of energy purchased under the contracts will be determined at least annually and submitted to the CPUC. Under the terms of the rate agreement between the CPUC and DWR, the CPUC is required to implement power charges such that the Fund will receive necessary monies to meet its revenue requirements.

The financial responsibility for the contracts may be transferred to the IOUs as part of a complete assignment of the contracts and release of DWR or its successor. However, there are a number of issues to be addressed, including IOU acceptance of the assignment and counterparty approval, before the contracts can be assigned.

Department of Water Resources Electric Power Fund**Statements of Net Assets****September 30, 2005 and June 30, 2005****(in millions)**

	September 30, 2005	June 30, 2005
Assets		
Long-term assets:		
Restricted cash and investments:		
Operating Reserve Account	\$ 555	\$ 555
Debt Service Reserve Account	927	927
Recoverable costs, net of current portion	7,358	7,356
Total long-term assets	<u>8,840</u>	<u>8,838</u>
Current assets:		
Restricted cash and investments:		
Operating and Priority Contract Accounts	1,060	1,387
Bond Charge Collection and		
Bond Charge Payment Accounts	773	570
Other investments	325	80
Recoverable costs, current portion	580	573
Interest receivable	35	26
Total current assets	<u>2,773</u>	<u>2,636</u>
Total assets	<u>\$ 11,613</u>	<u>\$ 11,474</u>
Capitalization and Liabilities		
Capitalization:		
Net assets	\$ -	\$ -
Long-term debt:		
Revenue bonds	10,518	10,529
Total capitalization	<u>10,518</u>	<u>10,529</u>
Current liabilities:		
Current portion of long-term debt	453	453
Accounts payable	479	424
Accrued interest payable	163	68
Total current liabilities	<u>1,095</u>	<u>945</u>
Commitments and contingencies (Note 6)		
Total capitalization and liabilities	<u>\$ 11,613</u>	<u>\$ 11,474</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund
Statements of Revenues, Expenses and Changes in Net Assets
For the three months ended September 30, 2005 and 2004

(in millions)

	2005	2004
Operating revenues:		
Power charges	\$ 870	\$ 1,265
Surplus sales	139	65
Total operating revenues	<u>1,009</u>	<u>1,330</u>
Operating expenses:		
Power purchases	1,140	1,426
Administrative expenses	11	17
Deferral of recoverable operating costs	(142)	(113)
Total operating expenses	<u>1,009</u>	<u>1,330</u>
Income from operations	-	-
Bond charges	216	243
Interest income	38	25
Interest expense	(114)	(110)
Recovery of recoverable debt service and related costs	<u>(140)</u>	<u>(158)</u>
Net income	-	-
Net assets, beginning of period	-	-
Net assets, end of period	<u>\$ -</u>	<u>\$ -</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund**Statements of Cash Flows****For the three months ended September 30, 2005 and 2004****(in millions)**

	2005	2004
Cash flows from operating income:		
Receipts:		
Power charges	\$ 884	\$ 1,206
Surplus sales	118	87
Payments for power purchases and administrative expenses	(1,341)	(1,440)
Net cash used in operating activities	<u>(339)</u>	<u>(147)</u>
Cash flows from non-capital financing activities:		
Receipt of bond charges	216	233
Interest payments	(30)	(22)
Net cash provided by non-capital financing activities	<u>186</u>	<u>211</u>
Cash flows from investing activities:		
Investments purchased	-	(20)
Interest received on investments	29	14
Net cash provided by (used in) investing activities	<u>29</u>	<u>(6)</u>
Net (decrease) increase in cash and investments	(124)	58
Restricted cash and investments, beginning of period	<u>3,439</u>	<u>3,381</u>
Restricted cash and investments, end of period	<u>\$ 3,315</u>	<u>\$ 3,439</u>
Reconciliation of operating income to net cash used in operating activities:		
Income from operations	\$ -	\$ -
Changes in net assets and liabilities to reconcile operating income to cash net used in operations:		
Recoverable costs	(149)	(150)
Net unrealized gains in other investments	(245)	(17)
Accounts payable	55	20
Total adjustments	<u>(339)</u>	<u>(147)</u>
Net cash used in operating activities	<u>\$ (339)</u>	<u>\$ (147)</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

September 30, 2005

(in millions)

1. Reporting Entity

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (the Fund), administered by DWR, was established in January 2001 through legislation adding Division 27 to the California Water Code (the Code).

DWR currently purchases power from wholesale suppliers under contracts entered into prior to January 1, 2003 for resale to ten million customers of Pacific Gas & Electric Company, Southern California Edison Company, and San Diego Gas & Electric Company (collectively referred to as the investor owned utilities or IOUs). The Code prohibits DWR from entering into new power purchase agreements, but allows DWR to enter into gas purchase contracts to provide fuel for power generated under its power purchase agreements.

DWR power is delivered to the customers through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the California Public Utilities Commission (CPUC).

Under the terms of a rate agreement between DWR and the CPUC, the CPUC will implement DWR's determination of its revenue requirements by establishing customer rates that will meet DWR's revenue needs to insure the payment of debt service, power purchases, administrative expenses and changes in reserves.

2. Summary of Significant Accounting Policies

Basis of Presentation

The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. As allowed by governmental accounting standards, the Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenses.

The financial statements of the Fund are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the business-type activities and major funds of the State of California that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of California as of September 30, 2005 and 2004, and the changes in its financial position and its cash flows, where applicable, for the periods then ended in conformity with accounting principles generally accepted in the United States of America.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

September 30, 2005

(in millions)

3. Restricted Cash and Investments

The State of California has a deposit policy for custodial credit risk. As of September 30, 2005, \$41 million of the Fund's cash deposits was exposed to custodial credit risk as follows:

Institution	Amount	Custodial Credit Risk
Prime Value Obligations Fund		
Institutional Shares	\$ 30	Insured
U.S. Bank	11	Uninsured and uncollateralized
	<u>\$ 41</u>	

As of September 30, 2005, the Fund had the following investments:

Investment	Maturity	Fair Value
State of California Pooled Money		
Investment Account - State Money		
Investment Fund	5.5 months average	\$ 2,704
Guaranteed investment contracts	May 1, 2022	500
Forward purchase agreement	November 1, 2005	100
Natural gas futures and options	3 months average	279
Other	5 year average	16
		<u>\$ 3,599</u>

The Fund's investments in the guaranteed investment contract and forward purchase agreement are rated as follows, by Standard & Poors (S&P) and Moody's, respectively, at September 30, 2005:

	Amount	S&P	Moody's
GIC Providers			
FSA	\$ 100	AAA	Aaa
XL Capital	150	AAA	Aaa
Royal Bank of Canada	100	AA-	Aa2
Sun America	150	AA+	Aa1
	<u>\$ 500</u>		
FPA Provider			
Merrill Lynch: FHLMC			
Discounted Notes	<u>\$ 100</u>	AAA	Aaa

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Notes to Financial Statements

September 30, 2005

(in millions)

4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the three months ended September 30, 2005:

	Revenue Bonds	Unamor- tized Premium	Total Revenue Bonds
Balance, June 30, 2005	\$ 10,696	\$ 286	\$ 10,982
Amortization of premium		(11)	(11)
Less current portion	(410)	(43)	(453)
Balance, September 30, 2005	<u>\$ 10,286</u>	<u>\$ 232</u>	<u>\$ 10,518</u>

The revenue bonds, all of which except Series E are tax-exempt, consist of the following at September 30, 2005:

Series	Rates	Fiscal Year of Final maturity	Fiscal Year of First Call Date	Amount Outstanding
A	3.0-6.0%	2022	2012	\$ 6,196
B	Variable	2020	Callable	1,000
C	Variable	2022	Callable	2,750
D	Variable	2022	Callable	500
E	4.3%	2006	Not callable	250
				<u>10,696</u>
Plus unamortized bond premium				275
Less current maturities				<u>(453)</u>
				<u>\$ 10,518</u>

The interest rates for the variable debt for the three months ended September 30, 2005, ranged from 1.50% to 2.95%.

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(in millions)

Future payment requirements on the revenue bonds are as follows at September 30, 2005:

Fiscal Year	Principal	Interest ¹	Total
2006	\$ 410	\$ 340	\$ 750
2007	427	436	863
2008	449	416	865
2009	471	394	865
2010	495	373	868
2011-2015	2,898	1,498	4,396
2016-2020	3,768	745	4,513
2021-2022	1,778	95	1,873
	<u>\$ 10,696</u>	<u>\$ 4,297</u>	<u>\$ 14,993</u>

¹ Variable portion of interest cost calculated using the September 30, 2005 Bond Market Association Municipal Swap Index (BMA).

5. Interest Rate Swaps

The terms, fair values, and credit ratings of counterparties for the various swap agreements at September 30, 2005 are summarized in the following table:

Outstanding	Fixed Rate	Variable Rate ¹	Fair	Swap	Counterparty			
Notional	Paid by	Received by	Value	Termination	Credit Rating			
Amount	Fund	Fund		Date	S&P	Moody's	Fitch	
\$ 94	2.914%	67% of LIBOR	\$ (1)	May 1, 2011	AAA	Aaa	AAA	
234	3.024%	67% of LIBOR	-	May 1, 2012	AAA	Aaa	AAA	
200	3.405%	BMA	(2)	May 1, 2013	A+	Aa3	A+	
100	3.405%	BMA	(1)	May 1, 2013	A+	Aa3	AA-	
30	3.405%	BMA	-	May 1, 2013	A+	Aa3	AA-	
194	3.204%	67% of LIBOR	(3)	May 1, 2014	AA-	Aa1	AA-	
174	3.280%	67% of LIBOR	(8)	May 1, 2015	AAA	Aaa	AAA	
202	3.342%	67% of LIBOR	(4)	May 1, 2016	AA	Aa2	AA	
202	3.389%	67% of LIBOR	(5)	May 1, 2017	A+	Aa3	AA-	
<u>\$ 1,430</u>			<u>\$ (24)</u>					

¹ One month U.S. Dollar London Interbank Offered Rate or Bond Market Association Municipal Swap Index

The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions in notional amounts that follow scheduled amortization of the associated debt.

Fair Value: The reported fair values from the table above were provided by the counterparties, using the par value, or marked-to-market, method.

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(in millions)

Credit Risk: As of September 30, 2005, the Fund was not exposed to credit risk because the swaps had no or negative fair values.

Basis Risk: The Fund is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR (a taxable rate index). As of September 30, 2005, the variable rate on DWR's hedged bonds ranged from 1.84% to 2.72%, while 67% of LIBOR received on the swap was equal to 2.59%.

Rollover Risk: Since the swap agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt, there is no rollover risk associated with the swap agreements, other than in the event of a termination.

Swap Payments and Associated Debt: As rates vary, variable-rate bond interest payments and net swap interest payments will vary. As of September 30, 2005, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same, for their term were as follows:

Fiscal Year	Variable Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2006	\$ -	\$ 30	\$ 7	\$ 37
2007	-	39	9	48
2008	-	39	9	48
2009	-	39	9	48
2010	-	39	9	48
2011-2015	1,026	144	35	1,205
2016-2017	404	17	5	426
	<u>\$ 1,430</u>	<u>\$ 347</u>	<u>\$ 83</u>	<u>\$ 1,860</u>

6. Commitments and Contingencies

Litigation and Regulatory Proceedings

DWR is involved in lawsuits and regulatory proceedings that could impact power costs and future revenue requirements.

In July, 2001, the Federal Energy Regulatory Commission (FERC) initiated a proceeding to calculate refunds for inflated prices in the California Independent System Operator (CAISO) and California Power Exchange Corporation markets during 2000 and 2001. DWR purchased \$2.9 billion in energy to meet the CAISO's emergency needs during 2001. DWR is treated in the FERC refund proceeding as a seller of that energy to CAISO, and in May 2004, FERC issued an order requiring DWR to pay refunds on the \$2.9 billion in "sales" to the CAISO. The refund amount totals approximately \$2.2 billion on a gross basis, of which DWR could actually owe up to approximately \$150 million on a net basis, because DWR would be the primary recipient of the refunds FERC required DWR to pay. However, FERC also later ruled that, like all sellers, to the extent DWR could demonstrate that payment of the refunds would result in DWR's costs exceeding its revenues, DWR could request

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(in millions)

FERC to reduce the refunds that would be owed. DWR sold all energy to the CAISO at its cost of acquisition. In September 2005, DWR made a cost recovery filing to request such a reduction in its refund obligation. Also in September 2005, the Ninth Circuit Court of Appeals ruled that FERC could not require governmental entities such as DWR to pay refunds. Accordingly, DWR has two possible methods of eliminating its potential refund liability: (1) the cost recovery filing it has made with FERC; and (2) the claim, based on the Ninth Circuit's ruling, that FERC has no legal authority to order DWR to pay refunds. Should the Fund be required to pay any refunds as a result of this proceeding, the refunds would be recoverable from ratepayers through future revenue requirements.

There are a number of lawsuits and regulatory proceedings in which DWR is not a party but may be affected by the result. In one consolidated set of cases, the issue is whether and to what extent compensation is due from the State of California as a result of the State's commandeering of certain block forward contracts in early 2001. Certain market participants claim that they are entitled to damages in excess of \$1 billion, their estimation of the fair value of the block forward contracts at the time of commandeering. DWR paid approximately \$352 million for energy provided under the contracts, which expired in December 2001. Given the early state of the proceeding, it is not possible to predict or determine the outcome of this matter or to provide an estimate of any losses, if any, that may arise. However, management believes that the costs associated with this action will not have a material adverse effect on the Fund's financial position or liquidity. Should the Fund be determined to be the source of moneys to pay any damages resulting from this litigation, those damages would be recoverable from ratepayers through future DWR revenue requirements.

Management believes that the existing lawsuits and regulatory proceedings will be resolved in the fiscal year. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

Commitments

DWR has power purchase contracts that have remaining lives of up to twelve years. Payments under these contracts approximated \$1.3 billion and \$1.4 billion for the three month periods ended September 30, 2005 and 2004, respectively.

The remaining amounts of fixed obligations under the contracts as of September 30, 2005, are as follows:

Fiscal Year	Fixed Obligation
2006	\$ 1,898
2007	2,525
2008	2,379
2009	2,238
2010	1,805
Thereafter	1,638
	<u>\$ 12,483</u>

In addition to the fixed costs there are variable costs under several of the contracts. Management projected as of September 30, 2005 that the amount of future fixed and variable obligations associated

Department of Water Resources Electric Power Fund

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September 30, 2005

(in millions)

with long-term power purchase contracts would approximate \$24 billion. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas.

Most of the power purchase contracts qualify as normal purchases and normal sales under the provisions of Governmental Accounting Standards Board Technical Bulletin 2003-1 (GASB TB 03-1), Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets. As a result, market valuation and certain risk information are not required to be disclosed.

However, five contracts do not qualify as normal purchases and normal sales under the provisions of GASB TB 03-1 primarily resulting from either pricing terms that contain variables which are not clearly and closely related to the base energy price or the seller is not a generator of electricity. As a result, certain information regarding these power purchase contracts is required to be disclosed. The fair value of these five contracts at September 30, 2005 approximated \$(104) million, using forward market prices discounted at DWR's internal cost of capital. These contracts, with a total capacity of 2,385 MWh, expire at various times, from December 2005 through December 2011.

7. Subsequent Event

On December 1, 2005 the Fund issued \$2.59 billion of variable rate refunding bonds to refund \$2.35 billion of 2002 Series A Bonds. In anticipation of the refunding, on October 11, 2005 the Fund entered into interest-rate swap agreements to pay fixed rates of interest and receive floating rate payments. Certain swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled and/or anticipated reductions in the associated "bond payable" category. The swap agreements are expected to reduce interest-rate risk associated with the variable-rate refunding bonds to be issued by the Fund. The Fund is exposed to potential loss in the event that a swap counterparty is unable to perform under the terms of the agreement. However, the Fund does not anticipate nonperformance by any swap counterparty.

The terms and credit ratings for these swap agreements as of October 11, 2005 are summarized below:

Outstanding Notional Amount	Fixed Rate Paid by Fund	Variable Rate Received by Fund	Swap Termination Date	S&P	Counterparty Credit Rating	
					Moody's	Fitch
\$ 355	3.184%	66.5% of LIBOR	5/1/2015	AA-	Aa3	AA-
486	3.228%	66.5% of LIBOR	5/1/2016	AA	Aa2	AA
480	3.282%	66.5% of LIBOR	5/1/2017	AA-	Aa2	AA-
514	3.331%	66.5% of LIBOR	5/1/2018	AA-	Aa3	AA-
306	3.256%	64% of LIBOR	5/1/2020	AA-	Aa3	AA-
453	3.325%	64% of LIBOR	5/1/2022	AA-	Aa2	AA
<u>\$ 2,594</u>						